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DEBT CONVERSION PROGRAMS

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Summary

Well-designed debt conversion programs can provide a financially viable means for recycling developing country debt to support development projects. Debt-for-nature and debt-for-development swaps can help highly indebted countries reduce their hard-currency obligations, enable U.S. and other foreign banks to reduce their exposure to potentially uncollectible debt, and provide nongovernmental organizations (NGOs) with a means of obtaining local currency funds to finance environmental conservation and other development projects in these countries.

Background

A debt swap in the simplest case involves a foreign bank, a developing country, and a third party—usually a nongovernmental organization. An NGO acquires from foreign banks a developing country's hard currency debt and subsequently exchanges it with the debtor country government for local currency funds. These funds are then used to support environmental conservation, other development projects, or local investments in the country.

USAID's role has not been as a signatory in the debt-exchange transaction. Instead, the Agency has provided financial aid to host countries and NGOs in debt swaps. Between 1987 and 1990, USAID grants totalling $1.4 million funded four debt swaps. USAID also helped establish and continues to help fund the Debt for Development Coalition Inc.—an umbrella organization that provides information and advice to member organizations interested in swapping debt to generate local currency funding for their development activities.

In late 1990, CDIE reviewed experimental approaches to debt-for-development and debt-for-nature swaps and reported the results in *Innovative Development Approaches* (January 1991). That report serves as the basis for this summary.

Findings

- **Well-designed debt conversion programs can provide financially viable means for recycling LDC debt to support development projects**. Such programs have helped some countries reduce their commercial debt significantly and attract private investors. If the secondary market for LDC debt continues to grow, private investors and NGOs can continue to use debt swaps to finance development activities.

- **Four conditions must be in place before a debt swap can successfully take place:** (1) The debt must be available through a donation or purchase at a substantial discount in the secondary market. (2) Funds for the debt purchase must be available in dollars or other hard currency. (3) The host country government must agree in writing to convert the debt into local currency at a rate significantly higher than the prevailing market rate. (4) The project to be financed through the proceeds of the debt conversion must be approved by the government and designed to address development issues as well as financial aspects of the debt conversion.

Widespread use of swaps is constrained by:

- **More debt than opportunities** to make profitable investments in major debtor countries. Moreover, much of the debt owed by these countries is not traded in the secondary market and therefore cannot be retired through debt swaps. A larger amount could be retired, however, if debt swaps were used in conjunction with a comprehensive debt-management program involving restructuring of the economy and a refinancing plan.

- **NGOs' lack of capability**, in both human and financial resources, to function effectively as intermediaries in debt swaps. The process of working out a transaction acceptable to all parties requires considerable time, negotiating skills, and technical expertise. Given the considerable staff resources, transaction costs, and time required to undertake a debt swap, it might be financially feasible for an NGO to proceed with a debt swap only if large sums of hard currency (e.g., at least $1 million) are to be converted.

- **Debtor countries' situations.** Few countries have formal debt conversion programs; some deal only with debt-equity conversions and don't provide clear guidelines for debt-for-nature swaps initiated by NGOs. The absence of a formal program may reflect the government's unwillingness to use debt swaps as a means of repaying its external debt, fearing for example that debt conversions could aggravate inflation. Some countries may have little commercial foreign debt; others' debt has already been written off. Thus, the secondary market for their debt is either nonexistent or so thin that it is nearly impossible to obtain information regarding fair market prices for their commercial debt.

Macroeconomic issues in debt conversion programs include:

- **Whether debtor government subsidies to those who redeem its debt are an efficient allocation of resources.** Supporters of debt conversions view these subsidies as justifiable costs to motivate private investors and development NGOs to invest in risky economies. Skeptics argue that the costs are unjustified because debt conversions provide little real debt relief. The key issue is "additionality," that is, whether investments derived from debt conversions would have been made without subsidies. A 1989 study of 101 debt conversions in Argentina, Brazil, Chile, and Mexico supports the argument that debt conversions attract foreign direct investments.

- **What potential exists for increasing domestic debt and inflatio**n. To meet the domestic debt obligations created by debt swaps, debtor governments have to raise revenues or resort to deficit financing. Deficit financing could mean that the government ends up paying more for the converted debt than it would have paid on the original obligation. Also, the government may exacerbate local inflation because currency generated by debt swaps enters the country's monetary system as new money, thus expanding the money supply. Brazil's experience with a 1988 debt swap is a worst-case scenario that illustrates the potential inflationary effects of large-scale debt conversions. The result was a frenzy of currency speculation and capital flight.

Recommendations

NGOS should:

- **Consider carefully whether a debt swap is the appropriate mechanism** to raise funds for a proposed project: Obtain technical and financial management help directly (if a large organization) or through the USAID-sponsored Debt for Development Foundation (if a small NGO).

- **Weigh all costs of undertaking a debt swap** against the costs of procuring local currency through other means. Purchasing debt owed to a multinational corporation that no longer operates in the host country or simply converting small sums of dollars using the official exchange rate are two possible alternatives.

Debt-swap programs should:

- **Include strong government commitment** to implementing policies that favor private investments and NGO-managed development activities.

- **State clear ground rules for local currency payments** (cash or bonds) or, in the case of debt equity conversions, repatriation of profits.

- **Protect against inflation and local currency devaluation**.

- **Define clear criteria for eligibility** of development projects for debt swaps.

USAID should:

- **Be prepared to address problems** related to the disbursement and management of Agency funds for debt purchases and be flexible in synchronizing the disbursement of funds with the NGO's need for them.

- **Assist countries establish debt conversion programs as part of a broader strategy** and in conjunction with an economic reform program to stimulate private investment and improve external debt management.

- **Educate senior government officials** about the potential role of debt conversion programs in stimulating investment in environmental conservation and other development activities. USAID could also fund technical assistance and training programs to help developing country governments and NGOs in establishing and implementing debt conversion programs.